

**CONTRACTING OUT
MUNICIPAL
PUBLIC SERVICES:**

**TRANSPARENCY,
PROCUREMENT,
AND PRICE SETTING ISSUES**

THE CASE OF HUNGARY*

Prepared for

Prepared by

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ABSTRACT

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The opinions expressed in this report are those of the author and do not necessarily represent the opinions of the sponsors of this report.

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CONTRACTING OUT MUNICIPAL PUBLIC SERVICES: TRANSPARENCY, PROCUREMENT, AND PRICE SETTING ISSUES THE CASE OF HUNGARY

INTRODUCTION

General

The purpose of this report is to address transparency, procurement, and price setting issues related to contracting out of public services. For additional background on contracting out issues in Hungary, one should review a report which was prepared in 1996 under the sponsorship of the British Know-How Programme, *Market-Competition-Contract*.¹

Numerous interviews of Hungarian local officials were undertaken as a part of this study and are central to its analysis.² Brief comparative information is provided on European and US experiences. Concurrently with the preparation of this report, reports on related local government issues are being prepared by Hungarian and foreign experts under the auspices of the World Bank subnational development program, the Urban Institute and the Hungarian Metropolitan Research Institute, with support from USAID, the Hungarian office of the Canadian Urban Institute, with support from the Canadian International Development Agency, and the British Know-How Fund, Local Government Program.

As a part of the trend towards the incorporation of cost concepts and competitive market principles into the provision of public services, in recent decades, throughout the world there has been a movement toward increased contracting out of government services on a competitive basis. In one place or another, almost every type of public service has been contracted out, including schools, prisons, and cemeteries.

A principal theory behind contracting out is that it decreases the cost and increases the quality of public services. Since government services involve large portions of national and local economies and employment, the pros and cons of contracting out have been the subject of a large quantity of literature.

Available from "Local Government Know How Project", H-2094 Nagykovacsi, Kolozsvari utca 22/a, Hungary.

Officials from Dunaharaszti, Eger, Nagykanizsa, Nyiregyhaza, Tatabanya, several towns with a population of less than 2,000, the Ministries of Finance, the Treasury, Transport, Communication, and Water Management, the Council on Public Procurement, numerous Hungarian private consultants on local government issues, and industry representatives were interviewed.

The author has not made references to specific cases because the purpose of this report is to address overall policy issues rather than provide a detailed critical analysis of the practices of particular cities or public agencies. The author appreciates the substantial cooperation received from local government officials, in providing information and their viewpoints.

The switch from government provision to contracting out places the local government in the role of regulator of the price and quality of services. Where services are contracted out for a substantial period of time price adjustments are required.

In Hungary, it has become common for local governments to contract out solid waste disposal, park and street maintenance services, and parking fee collection to private firms on a competitive basis. In some cities, water provision has been contracted out. It is likely that contracting out will increase in the coming years because private firms are often needed in order to obtain the financing necessary for capital improvements, which are necessary to maintain public services. While contracting out to private firms may be new in Hungary, contracting out issues are not totally new because "contracting" out of the provision of a wide range of public services to semi-autonomous publicly owned corporations has been a tradition.

The Role of Local Services in the Hungarian National Economy and Local Budget

As background, especially for non-Hungarian readers, it should be noted that local government expenditures constitute approximately ten percent of GDP in Hungary, compared to central government expenditures which are approximately forty percent of GDP.³

Locally generated revenues which are paid to local governments provide about twenty percent of local revenues. Out of the eighty percent balance, about seventy percent comes from central government transfers. Most of this seventy percent comes from normative grants, shares of income taxes paid by local residents, and social security funds. About ten percent of local government revenues are coming from the sale of assets. The cost of most local services are covered with a combination of the grants from the central government and local revenues. Out of the local government expenditures about 40 percent go toward education and about 25 percent to health expenditures.

During the Communist era, local governments served almost solely as agents of the central government with very little local revenue and discretion. On an intermediate level, 19 county councils played a central role in directing the local governments on behalf of the national government. In 1990, the national government adopted the *Law on Local Self-Government*,⁴ which largely reduced the role of the county governments, granted a

Department of Local Governments, Regional Development and Housing Policy, "Major Directions of Development of Local Governmental Regulations, with respect to the Requirements of the Accession to the European Union," (February 1998), p. 6, Table 2. Extra-budgets and social security funds are included in the forty percent estimate.

Act LXV of 1990.

substantial amount of power to local governments, and increased the number of local governments to 3,148. In Budapest, 22 district councils received a substantial amount of power and autonomy. Reactions to the exceptional centralization during the Communist era were a significant force in formulating the new arrangements.

A substantial portion of the population lives in small cities. Three quarters of the local jurisdictions have less than 2,000 inhabitants. Approximately one-third of the population lives in municipalities with a population of 5,000 or less. Another nine percent live in municipalities with a population between five and ten thousand. Under these circumstances, coordination among municipalities in order to achieve efficiencies of scale is a central issue.

Local Government Expenditures - 1997 (expected)⁵

Type of Expenditure	Gross Exp. (k
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Ministry of Finance, 1998 Budget of the Hungarian Republic (draft law), Volume I, p. 388.

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Nowadays, local governments are in a particularly difficult position in regards to the provision of public services. They need to charge for services that have been provided free of charge for decades, upgrade service quality and/or make up for years of deferred investment. These steps need to be taken within the context of severe budget constraints. Furthermore, a significant portion of the population cannot afford to pay for services, trapping the service provider between cost recovery and welfare functions. (The most extreme example is the case of low income and retired households served by district [master-metered] heating which commonly costs more than half of the household income in the winter months).

Hungarian Institutional Incentives for Contracting Out Public Services

While much of the world institutional and theoretical support for contracting out is based on the concept that such an approach is in itself more efficient, in Hungary, two regulatory factors provide major economic incentives for contracting out to a private or publicly owned company.

Private and public firms (companies) can employ labor far more cheaply than public entities. Companies, unlike public entities, may be able to subcontract out a substantial portion of their labor tasks on an "independent contractor" basis and thereby avoid social security payment requirements, which constitute about 42 percent of wages.⁶ Furthermore,

Depending on their bargaining power, employees may require that some of these savings be passed through to them. Employees are subject to social security taxes that are not paid by their employer, but can deduct business expenses before calculating the tax. Independent

the "independent contractor" arrangements enable employers to terminate employees at will.

Companies also may obtain refunds of their VAT (value added tax) payments, while government entities cannot obtain a refund. This tax adds about 25 percent to the cost of local services.

PRINCIPLES OF CONTRACTING OUT: INSTITUTIONAL PREREQUISITES, "BEST PRACTICES", AND CRITICAL COMMENTS ABOUT CONTRACTING OUT

Contracting out has been actively advocated by international finance organizations including the World Bank, OECD, and the IMF and national governments, especially Great Britain, on the basis that it reduces the cost, increases the efficiency of public services, and helps develop the private sector.⁷ On the other hand, some scholars on the issue have reached mixed conclusions or have concluded that it is no more efficient than in-house provision of public services.⁸

A critical caveat of this report is that the contracting out of each type of public service has its own special characteristic and principles and demands its own set of special strategies and institutions, which should be explored before specific transformations to contracting out are undertaken. For example, some services may be contracted out on a short-term competitive basis while others require long-term contracts with price adjustments based on cost reviews. Furthermore, the national and local institutional circumstances of various public services, relating to their level of efficiency and corruption, greatly differ. Contracting out has worked much better for some types of services than others. (There is an extensive body of literature in English about the contracting out of each type of public service).

While much of the literature on contracting out notes the savings that have been obtained, there are substantial differences between contracting out public services that can be provided on a competitive basis, with periodic renewal of competition, and services that require longer term monopoly provision. As a UN report notes: "The transfer of a public monopoly into private hands is not an ideal solution, as efficiency gains might not be

ractors, unlike employers, can decide whether or not they will make social security contributions.

See e.g., the publications cited in note 10 *infra*. For discussion of some of the determinants of what public services have been contracted in the U.S. see Silanes, Shleifer, and Vishny, "Privatization in the United States," *Rand Journal of Economics*, Vol. 28, No. 3, Autumn 1997, 471.

See e.g., Ascher, *The Politics of Privatisation* (London: Macmillan, 1987); ed. Thomas Clarke and Christos Pitelis, *The Political Economy of Privatization* (London: Routledge, 1993).

transferred to customers, but retained by the operator in the form of monopoly profits."⁹

In light of the foregoing, it is important to note that in general it makes sense to "unbundle" the various aspects of service provision and to contract out the portions of the service that can be provided on a competitive basis. Typically, those portions are less capital intensive.

Conventional "Best Practices"

In the course of their efforts, the various international organizations (e.g., United Nations, World Bank, OECD) have set forth basic lists of best practices in implementing contracting out policies.¹⁰ The following list is based on criteria set forth in those reports:

- Secure top government management and encourage reevaluation of tasks and processes.
- Focus on staff issues and consult with current employees.
- Specify service requirements in terms of outcomes or outputs.
- Monitor performance and foster co-operative relationships.
- Ensure valid comparisons, by considering all of the real costs and benefits of contracting out.
- Evaluate in-house bids according to the same criteria as outside bids.
- Foster competitive markets by selecting the appropriate size of contracts.
- Develop and maintain the necessary skills to oversee contracting out.

United Nations Conference on Trade and Development, *Comparative Experience with Privatization*, (New York and Geneva, 1995), p. 15f

⁹ See e.g., Council of (U.S.) State Governments, "Privatization," *State Trends and Forecasts*, Vol. 2, Issue No. 2 (Lexington, Kentucky 1993); OECD (Organisation for Economic Cooperation and Development), *Contracting Out Government Services, Best Practices, Guidelines and Case Studies*, Occasional Paper No. 20 (Paris, 1997); United Nations Conference on Trade and Development, *Comparative Experiences with Privatization* (New York and Geneva, 1995); United States General Accounting Office, *Privatization Lessons Learned by State and Local Governments* (Washington, D.C. GAO/GGD 97-48, 1997); World Bank, Christine Kessides, *Institutional Options for the Privatization of Public Services* (Washington, D.C. 1993).

"Procedural" Prerequisites

- Use competitive public procurement procedures.
- Establish an independent and competent review and regulatory mechanisms before privatizing.
- Establish "transparent" procedures for public action.

**CONTRACTING OUT OF SERVICES BY HUNGARIAN LOCAL GOVERNMENTS
(MUNICIPALITIES AND COUNTIES)*****Contracting Out in Hungary***

Interviewees consistently indicated that it has become standard practice for cities to create one or more municipally owned companies which are responsible for park, road maintenance, snow clearing, refuse collection, and cemetery services. In turn, some of these services are subcontracted out to private firms.

Typically, park maintenance services are divided into sections of the city and subcontracted out on a section by section basis, resulting in numerous subcontractors for this service. (The typical length of such contracts is 3 to 5 years). Refuse collection services are commonly contracted out to foreign firms when significant capital investments are required in order to create new disposal sites. In such cases, 25 year contracts were common. It was estimated that about 10 percent of all water services are contracted out to private investors. As indicated, the level of contracting out might increase substantially as cities try to obtain capital in order to upgrade services. Interviewees commonly indicated that contracting out led to more efficient provision of services and/or indicated that, because local governments had the option of contracting out, municipally owned service providers operated in a more efficient manner.

Procurement Standards and Practice—Public Services Contracts

General Description—Hungarian Standards

Hungary has adopted detailed legislation on procurement standards (Act XL of 1995), modeled after the standards set forth in EU procurement directives. However, in keeping with the price differences between Hungary and West Europe the contract sums that trigger coverage by the procurement law (thresholds) are far lower in Hungary. In accordance with the procurement act, the Hungarian thresholds are set forth in the Annual Act on the Budget.

Coverage of Procurement Act

Type of Contract	Thresholds for Coverage By Procurement Law	
	Hungarian Standard	EU Standard
Goods	15m HUF (62,600 ECU)	400,000 ECU
Public services	7.5m HUF(31,300 ECU)	600,000 ECU
Public works	30m HUF (125,200 ECU)	5,000,000 ECU

The Procurement Council indicated that there has been some discussion about raising the thresholds to EU levels. While such a step may be literally consistent with EU policy, in practice, it would exempt a segment of public services that are covered in the rest of the EU.

In addition, two other laws govern public procurements: The Act on Concessions,¹¹ which includes in its coverage contracts for the operation of local public utilities,¹² and the Act on Water Management.¹³ Both of these acts contains additional tendering standards beyond those set forth in the Procurement Act.

The Extent of Tendering Out

The Council on Public Procurement prepares reports on the volume of tendering by public agencies. Overall, tendered contracts equaled approximately seven percent of government

¹ Act XVI of 1991, Sections 4-10.

² Section 1(d).

³ Act LVII of 1995, Sec. 11.

expenditures.¹⁴ The percentage was at least double for municipal governments.¹⁵

Public Procurement Council Database

Tendered Contracts¹⁶ Type of Procedure (1997)

<i>Type of Tender Procedure</i>	<i>Amount of Contracts Awarded</i>
Open Procedures	209 bn HUF (\$1bn)
Invitation Procedures	11 bn HUF (\$55m)
Negotiated Procedures	74 bn HUF (\$370m)

Tendered Contracts Level of Government

<i>Level of Government</i>	<i>Amount of Contracts Awarded</i>
Municipalities	135 bn HUF
Public Service Providers	81 bn HUF
Central Budgetary Organizations	55 bn HUF
Other	20 bn HUF

Tendered Contracts

<i>Type of Contract</i>	<i>Amount of Contracts Awarded</i>
Products	108 bn HUF
Construction	135 bn HUF
Services	48 bn HUF

The Council on Public Procurement

The Act provides for a Public Procurement Council which monitors the implementation of the

¹⁴ This sum is calculated by dividing the 292 bn HUF in tendered contracts by the General Government expenditure level of 4166 bn HUF in the 1998 Budget, *supra* note 5.

¹⁵ Municipalities awarded 135 bn HUF in contracts through tenders, which compares with gross expenditures of 914 bn HUF. However, tenders by public service providers are not included in the 135 bn HUF total of local governments.

¹⁶ Source: Public Procurement Council, data base. The totals in the tables differ slightly due to rounding.

law by local and national agencies.¹⁷ In a recent report the Council commented that "In Hungary, and such is the case in the other countries in the region, budget entities lack the trained staff needed for a professional management of public procurement. This is particularly relevant in the case of local governments and smaller budgetary institutions."¹⁸

The Council has a staff of 12 full-time arbitrators, who review complaints. The arbitration committee received 267 complaints in 1997. According to Council staff, most of the complaints involved claims that a local government failed to follow its own criteria in awarding a contract.

Public Services Contracts—Exemptions from the Public Procurement Act

While the act applies to public procurements generally, several key information sources indicated that it does not apply to contracts for the provision of services which are supported solely by user fees.¹⁹ In reality the principal exemptions created by this provision are for solid waste services supported solely by user fees. (If the service is partly paid for out user fees and partly subsidized, it is covered by the procurement act). Furthermore, while a contract with a private company to provide user fee funded services is exempted from the procurement law, purchase activities of that private company (e.g., the purchase of trucks by a waste disposal company pursuant to the performance of public service) is covered by the act. The exemption is based on the concept that the contracting public agency does not provide any consideration for the service; instead, the service is paid for by private citizens. A separate act covers contracting out of refuse collection and chimney services.²⁰ But, it does not set forth standards for these tenders.

In some interviews, directors of municipally owned (kft or kht) companies indicated that they were not covered by the procurement legislation and that their subcontracting for public services was not subject to the Procurement Act. Other knowledgeable sources indicated that localities were claiming exemptions on the basis that under the Procurement Act "public service providing activity" only covers activities "qualified by...municipal by-law as public service, activity provided by an institution in the public service, public utility or communal service."²¹ One Hungarian expert on procurement indicated that the central and local governments commonly conclude that transfers of public services to private NGOs are not subject to procurement requirements based on the concept that the service is for a third party rather than for the government.

⁷ Act XL of 1995, Part II, Secs. 11-23.

³ Council on Procurment, "Brief Review of the Status of Public Procurement in Hungary," prepared for International Conference on Tende
enhagen, June 1998.

³ Act XL of 1995, Sec. 9(1).

³ Act XLII of 1995.

¹ Act XL of 1995, Sec. 10(e).

Therefore, under this concept, the contracts do not involve public purchases of products or services (the government agency is "giving money" to the NGO rather than "paying" for its service).

In this author's opinion, exemptions for public service contracts from Hungarian procurement requirements are contrary to the purposes of the procurement legislation which include: establishing the transparency of the use of public funds and its wide-ranging public controllability, furthermore, providing for the purity of competition in the course of public procurements....²² The concept that there should be an exemption or a less stringent procurement rule because the payment for a public service comes directly from the private users rather than with public funds or that the service goes directly from the private company to the user exalts form over substance. Public funds for all services come from taxes paid by private individuals. The interest of the citizen in securing the benefits of the procurement act are the same whether the service and/or the payment for the public service is directly between the government agency and the citizen or via the contracting party.

In contrast, the EC directive contains broad definitions of "public authorities" and "public undertakings" which include authorities which are effectively controlled by public entities. This coverage includes entities which "operate on the basis of special or exclusive rights granted by a competent authority of a Member state." (Title I, Article 2, Sec. 1(b).)

The EC definitions of "public authorities" and "public undertakings" are as follows:

■ **Public Authorities**—shall mean the State, regional or local authorities, bodies governed by public law, or associations formed by one or more of the authorities or bodies governed by public law.

■ **Public Undertaking**—shall mean any undertaking over which the public authorities may exercise directly or indirectly a dominant influence by virtue of their ownership of it, their financial participation therein, or the rules which govern it. A dominant influence on the part of the public authorities shall be presumed when these authorities, directly or indirectly, in relation to an undertaking:

- Hold the majority of the undertaking's subscribed capital, or
- Control the majority of the votes attaching to shares issued by the undertaking, or
- Can appoint more than half of the members of the undertaking's

² Act XL of 1995, Introduction.

administrative, managerial or supervisory body...(EC Directive 93/38/EEC, Title I, Article 1)

In the course of interviews, this author found substantially differing opinions as to the scope of the Hungarian Procurement Act and statements the law clearly did not allow for some of the interpretations which other experts claimed were common. Further clarification and possibly simplification, which obviates the need for substantial cross-referencing to other legislation, might bring about greater uniformity of interpretation.

Eu Conclusions about Hungarian Public Procurement Standards and Hungarian Plans for Future Amendments to the Procurement Act

The EC Commission, while commenting that "Hungarian legislation on public procurement is largely compatible with EC directives in this field," has noted that: "...the Hungarian legislation does not meet all the requirements of EC Directives regarding the utilities sectors (namely energy, telecommunications, water, and transport)."²³ Interviewees from the Ministry of Justice and the Procurement Council indicated that plans were underway to take the steps that would be necessary to bring the Hungarian standards in conformance with the EU standards by the time of accession. However, there were differences in opinions among the interviewees as to the extent of diversion between the EU standards and Hungarian law.

Interim Preferences for Hungarian Companies

Under the current law, a public agency may prescribe that the tender will be awarded to residents of Hungary, or that the Hungarian bidder will be favored if its bid is not more than ten percent above a competing foreign bid.²⁴ In accordance with EU accession agreements, it is required that these preferences will be phased out.

Enforcement and Implementation of the Procurement Act Standards

Staff of the Council on Procurement stated that most non-compliance was not intentional and that the most serious problems result from a lack of understanding of the law. It indicated that frequently local agencies draft implementation regulations that are not consistent with law. The Council is considering preparing a procurement package for localities. Several interviewees noted that bidders are hesitant to complain about violations of the rules out of fear of retaliation in future tender evaluations. In a study covering the

³ Commission of the European Communities, "Commission Opinion on Hungary's Application for Membership of the European Union", 15.07.97; COM (97) 2001 final).

⁴ Act XL of 1995, Sections 26(3) and 59(2) and (3).

period up until the end of 1996, the State Audit office concluded that "a considerable part of public procurement procedures were conducted in deviation from the rules."²⁵ For a general critique of the operation of the procurement law see Bonifert Donat and Futo, "Accessibility and Transparency of the Public Procurement Process in Hungary."²⁶

Non-transparency of Public Contracts and Information Used to Justify Price Adjustments

Hungarian Practice

With only a few exceptions, local officials took the position that contracts by public entities with private companies were not public records and, therefore, citizens do not have the right to obtain such documents. As a result, information about what might be in the contracts was limited to information contained in the tender announcement. In some cases, inquiries as to whether such records were public domain made local officials rather uncomfortable. In some cases, mixed responses were given; the local official responded that in principle the contracts were public, but that in practice nobody had requested copies of contracts and they were not given out. In other cases, such requests were viewed as unreasonable.

Hungarian Law

Contrary to the nearly universal public practice, Hungarian lawyers who were interviewed believed that contracts by public entities are public records. While Hungarian authorities are more restrictive than West European authorities in regards to access to public contracts and commercial information submitted to public authorities, Hungarian law appears to have stronger public access standards than those of West Europe.

Under the Hungarian Constitution (Article 61)

"... everyone has the right to ... information of public interest..."

Furthermore, under the Hungarian Law "On the Protection of Personal Data and Accessibility of Data of Public Interest,"²⁷ the authorities are required to grant access for

⁵ Quotation from State Audit Report (title not provided) in Bonifert and Futo, *infra* note 26 at p.30.

³ Ch. 3 of *Accessibility and Transparency of the Public Procurement Process in Hungary, Albania, and the Slovak Republic*, Foundation for a Market Economy, Budapest, May 1998.

⁷ Act No. LXIII of 1992. For a discussion of the Act and related background information see Hungarian Civil Liberties Union, *Data Protection and Freedom of Information* (Budapest 1997). The report is published in English and Hungarian and includes a translation of the Data Protection Act.

anyone to the data of "public interest," unless the data is specifically restricted by law. (Article 19(3)). There is no specific exemption for commercial information. Furthermore, "data of public interest" is broadly defined to include: "any information under processing by an authority performing state or local self-government functions or other public duties, except for personal data." (Article 2, Sec.(3)) Another section of the law states that: "Access to data of public interest may not be restricted to protect those data of a person acting on behalf of the authority which are conjunctive to his or her duty." (Article 19(4)).

One exception to the above rules is that: "Unless an Act provides otherwise, data generated for internal use and in connection with the preparation of decisions shall not be public within thirty years following their inception." (Article LXIII of 1992, Sec. 19(5)) However, according to the legal experts interviewed, the apparent intent of this section is to protect drafts of proposed regulation prepared by a ministry, rather than to protect commercial information. Hungary also has a business secrets law, which protects "any fact, information, solution or data, connected to economic activities, the secrecy of which is in the reasonable interest of the entitled party."²⁸ Hungarian law does not set forth the relation between the Accessibility of Data and the Business Secret laws. However, in one opinion regarding the relationship between public funds and private business, the ombudsman stated that "The transparency and controllability of the privatisation processes, as public interest, takes precedence over the private interest of protection of business secrets."²⁹

Access in Other Nations to Public Contracts and Cost Data Used for Pricing

Access to public documents has been an area of increasing concern in recent decades. In 1982, the Council of Europe Committee of Ministers adopted a "Declaration on the Freedom of Expression and Information."³⁰ It states that they "seek to achieve the following objectives: the pursuit of an open information policy in the public sector, including access to information, in order to enhance the individual's understanding of, and his ability to discuss freely political, social, economic and cultural matters."³¹ Commonly, nations have adopted some type of Freedom of Information legislation.

Typically, access to public information legislation contains some type of exemption for commercial information, which has an undefined scope. Interpretation is largely left to the administrative agencies and the courts. Under U.S. laws, contracts by public entities are public record. The federal Freedom of Information Act contains an exemption for "trade

³ Act IV of 1978, Sec. 300.

³ Case No. 528/A/1996. (November 28, 1996).

³ 70th Session, 29 April 1982.

¹ Declaration, *ibid*, Sec. II(c).

secrets and commercial or financial information obtained from a person and privileged or confidential..."³² State laws, which govern contracts by state and local governments, contain similar provisions. Typically the commercial exemptions are interpreted narrowly. Generally, they provide an exemption for commercial information that is used to demonstrate that a company has the financial resources to undertake a project or to protect trade secrets. The common judicial test of whether a government agency can refuse to disclose business information is whether the release of the information would be damaging to the business or would discourage future competition for public contracts.

Under French law governing access to administrative documents,³³ there is an exception for commercial and industrial secrets.³⁴ A Commission d'Acces aux Documents Administratifs (CADA) is responsible for administering the law and making administrative determinations about access to particular documents. A commentary on the French act notes that the scope of the exception is not precise and that it has not been defined by the courts.³⁵ However, each of the sources contacted by this author indicated that contracts were considered public records.

Under British law, there is a non-statutory *Code of Practice on Access to Government Information*, which includes an exemption for "commercial confidences, trade secrets or intellectual property whose unwarranted disclosure would harm the competitive position of a third party". The "Guidance on Interpretation" issued by the Cabinet Office advises decision makers to ask three questions when deciding whether to withhold commercial information:

- Is the information a trade secret, a commercial confidence, or intellectual property? The Code suggests adopting the *Alberta Trade Secret Act 1986* definition of a trade secret. If the answer is "no" then the exemption does not apply. If the answer is "yes"
- Would its disclosure be likely to harm the competitive position of the subject or source of the information? If the answer is "yes", disclosure is unwarranted unless there is an overriding public interest in disclosure. If the answer is "no"

² 5 U.S.Code Ann. Sec. 9(b)(4). For discussion of the commercial exemption under the Freedom Information Act see American Civil Liberties Union, "Exemption 4, Business Information," *Litigation under the Federal Government Open Government Laws* (1992), ch. 6, pp. 75-80; and Herbach, "The Freedom of Information Act: An Examination of the Commercial or Financial Exemption," 16 *Santa Clara Law Review* (1976), pp. 193-213.

³ *Code Administratif*, Loi no. 78-753 du 17 juillet 1978.

⁴ *Id.*, Sec. 6.

⁵ Commission d'Access aux Documents Administratifs, *Guide de l'accès aux documents administratifs*, (3d. Edition 1998).

- Would its disclosure be likely to prejudice the future supply of information to the government? If the answer is "yes" then disclosure is unwarranted.³⁶

Presently, the Freedom of Information Unit of the Cabinet Office is drafting a Freedom of Information legislation for consideration by the Parliament which would replace the *Code of Practice*.

Under Austrian law, public agency contracts are not public record. However, a losing bidder in a tender has the right to see the contract that is made with the winner of the tender.³⁷

Under Swedish law, "access to official documents may be restricted only if the restriction is necessary having regard to, five, the public economic interest, six, the protection of economic conditions of private subjects."³⁸ The term "document" is broadly defined to include any document in the possession of a public authority.³⁹

For discussion of the commercial exemptions under the laws of Australia, Canada, France, Great Britain, Ireland, New Zealand, Sweden, and the United States see Richard Baxter's, "Commercial Confidentiality," in *Freedom of Information—Resolving Disputes*.⁴⁰

Is There a Rational Policy Basis for Maintaining the Secrecy of Public Contracts?

Maintaining the secrecy of public contracts seems to be based on a combination of European civil law distinctions between public and private matters, reactions to invasiveness of the Communist regimes, and a common view that private companies will be damaged by public disclosure of critical business data. Maintenance of the secrecy of public contracts is common in Western Europe, as well as Central Europe, although there has been a strong trend towards allowing increased access in recent decades.

³ Open Government, *Code of Practice on Access to Government Information*, Guidance on Interpretation, Cabinet Office 1994, Paragraph 1.

⁷ *Federal Law Gazette I* 1997/75, (Reissue), Sec. 56.

³ Freedom of Press Act, ch.2. On the Public Nature of Official Documents. Article 2.

³ *Ibid*, Article 3.

³ 1995 (Report prepared with British Government Research Fellowship). (Contact address for publication, rsb@clara.net) See also Baalman, "Public Access to Business Information Held by Government," *The Journal of Business Law*, May 1997, pp. 199-219.

The concept of secrecy of public contracts based on a theory that disclosure would be damaging to a company does not stand up under scrutiny. The best evidence of the truth of this statement is that wide scope of access allowed in the U.S., including access to public contracts, has not deterred private initiative and commercial activity. On the contrary, such disclosure has increased the credibility government use of private companies in the provision of public services.

The Substance of Contracts for Public Services

An original purpose of this project was to provide comment on public contracts with private companies for public services. To an important extent, this objective has been frustrated by the practice of keeping these contracts secret. It was possible to obtain information about significant provisions in contracts through interviews; but it was impossible to determine what critical information may have been omitted. Usually it was impossible to determine what rights and economic returns were granted to private investors who provided capital for public works.

Interviewees consistently indicated that they had not had problems under their contracts and that they would not draft their contracts any differently if they were rewritten today. However, the few contracts that were obtained by this author were very brief, leaving the details of payment, the level of service provision, and remedies for service breaches, and other matters to the scope of the tender invitation and oral or unstated understandings. Under these circumstances, frustration of objectives and expectations and future misunderstandings and disputes are inevitable.

The specific provisions of the contract may not be appropriate to the Hungarian circumstances. But it provides a view of what types of issues are covered in such a contract, which may be useful to Hungarian local officials, considering various types of contracts.⁴¹ The contract makes an effort to state as precisely as possible the requirements of each of the parties to the contract. For example, it states the times at which waste collection may take place and the holidays when no collection is required. Issues that are addressed in the attached contract include the following:

Summary of Contents of a U.S. Municipal Waste Contract

- The contents and frequency of the reports that must be submitted by the contractor
- All the types of facilities served by the contractor
- Standards for work performed by the employees of the contractor, including

¹ British Contracts are included in *Market -Competition -Contract*, *supra* note 1.

- treatment of the public
- Permissible hours of refuse collection
- Holidays when no collection is required
- What equipment is required
- What equipment may or may not be used
- Where equipment may be stored
- The standards for maintenance of the equipment and the storage facilities
- Information pamphlets to be supplied to the public by the parties
- Permits which the contractor must obtain
- The contractor must maintain continuous financial ability to perform the services
- Power of the municipality to demand the termination of an unsatisfactory employee
- Hours and facilities maintained by the contractor to receive complaints and reporting of complaints to the municipality
- Contractor designation of person, place to receive municipal communications
- Contractor shall comply with all applicable laws relating to the service provision
- Description of waste that contractor must collect
- Frequency of collection
- Where waste containers may/must be placed by residents
- Description of allowable types of containers
- Description of service required for each type of entity (single family houses, apartment buildings, factories, schools, public buildings)
- Recycling definitions, requirements, etc., covered in same detail as overall waste collection
- Allowable disposal sites
- Responsibilities for billing customers and collecting fees
- Schedule of payments by the municipality
- Penalties for late payments by municipality
- Adjustments in compensation to the contractor
- Right of municipality to conduct audits
- Form of records maintained by the contractor
- Notice by municipality and remedies if contractor fails to perform
- Insurance which must be maintained by the contractor
- Indemnification of municipality for damage caused by the contractor
- Interpretation of the contract, governing rules
- Municipal interpretations of the contract must be in writing
- Procedures for communicating disputes

Long-term Contracts

As previously indicated, long-term contracts are often made in order to obtain the benefits of private access to financing for necessary capital expenditures. However, it

should be understood that this approach poses substantial risks and has substantial drawbacks. Such contracts may effectively preclude the public from obtaining the economic benefits and/or service benefits of future innovations which increase efficiency or quality because a company with a long-term contract would not feel compelled to make the improvements and/or pass through the cost reductions to consumers. In effect, they remove many of the advantages associated with contracting out public services and lead to the loss of future cost control.

In one case, a major city has awarded a 25 year contract for refuse collection, with an annual Cost Price Index adjustment, which does not require capital improvements by the private company. The justification for this contract was that the private company would have the funds to upgrade the rolling stock. However, shorter contracts may accomplish the same result. Other cities have executed similar length contracts in conjunction with private investment in the creation of new waste disposal sites. Such contracts may have greater justification, but carry the same risks.

For example, greater competitiveness in the provision of waste disposal may be obtained by dividing service provision into separate contracts for the creation of a waste disposal site, which requires a long-term investment, and waste collection. One city services manager believed that such an approach would create unworkable conflicts of interest and that it would have to contract out the entire solid waste disposal process whenever it needed a new disposal site. A private company representative commented that if collection and operation of the disposal site were divided, it was likely that collection companies would use other illegal sites that charged lower fees. However, other cities are using this approach and another expert believed that such an approach would lead to more favorable results for municipalities.

SETTING PRICES FOR PUBLIC SERVICES

This section describes some of the basic concepts and issues associated with price setting. But, a more important purpose of this section is to address the issues associated with price setting procedures in Hungary.

Transparency and Secrecy of Financial Information Submitted in Price Setting Proceedings

As in the case of public contracts, submissions used for public price settings are not public record. The most significant example of this practice is that the submissions to the Ministry of Transport, Communication, and Water Management that are used to set water prices for the five regional companies—that is, the rates for 45 percent of the country—are not accessible under current practice. Furthermore, the submissions that are used to justify

local tariff subsidies for hundreds of water districts are not accessible.

Without public access to cost data the process cannot possibly be viewed as democratic and it will be impossible to develop the independent expertise that is essential to formulating critical independent understanding of price setting standards. Interviews revealed that local assemblies are not given sufficient information to make informed price setting decisions. Without access to the data submitted to the assemblies and decisions setting forth their reasoning it is not possible to know whether they had adequate expertise and whether their decisions were reasonable.

Obtaining Information Required for Price Setting Proceedings in an Adequate and Digestible Form

In order to review requests for price increases it is essential that information be obtained in a form that is manageable. When specific application forms are not provided to regulated entities, they commonly provide too little information or more information than the price setting agency can possibly digest.

Independent Expertise to Review Applications

It is critical that localities have the expertise to enter into and implement the contracting out of services. In light of the budget limitations faced by local governments, it is suggested that localities pool their resources in order to obtain the services of experts on an ongoing basis at a moderate cost.

Price Adjustment Formulas

Types of Formulas⁴²

Price setting is necessary whenever a service has to be contracted out for a substantial number of years and/or there is a monopoly supplier who cannot be replaced. The institution of price regulations in modern economies has been accompanied by continual debate over what formulas or standards should be used. Setting prices for public services has never been a simple task, with no single answer as to what may be the best approach. In Great Britain and the U.S. there have been constant revisions of price setting formulas and practices.

² For general discussion of price adjustment formulas see Beesley and Littlechild, "The Regulation of Privatized Monopolies in the U.K.," *Rand Journal of Economics*, Vol. 20, No. 3, Autumn 1989. For discussion of economic regulation and price regulation of water companies see Klein, "Economic Regulation of Water Companies," World Bank Private Sector Development Department, Policy Research Paper 3 (September 1996) and sources cited therein.

Price setting formulas may be roughly divided into two categories: a) rate of return and b) price index. Rate of return standards provide that prices shall cover actual operating expenses plus a specified rate of return on capital investment. Price index formulas range from simple formulas that use only one price index in order to adjust prices to complex formulas, which use a weighted price index reflecting the types of expenses incurred by the regulated service.

Hypothetical Weighted Index

(a) Factor	(b) Index	(c) Pct. Increase over Prior Year	(d) Weight	(e) Adjustment (c*d)
Wages	National Wage Index	12 percent	.55	6.6 percent
Fuels	Fuel Price Index	18 percent	.12	2.13 percent
Materials		10 percent	.10	1.00 percent
Vehicles		20 percent	.23	4.6 percent
Assessories & Parts				
Total Adjustment				14.36 percent

The cities contacted in this study used both rate of return and overall price index formulas for adjusting prices. Weighted price indexes were used in only a few instances. Eger uses a weighted index for adjusting water prices.⁴³

Comment on Rate of Return Standards

The strength of rate of return regulation is that it rewards increased investment and provides security for the investor. The criticism of the approach is that it provides no incentive for efficiency and encourages over capitalization.

As a practical matter, it is difficult to administer periodic reviews of cost increases in order to determine if they are reasonable. Determinations have to be made about whether particular expenditures are reasonable, when in reality there are constant tradeoffs (or a lack thereof) between quality and price. It is necessary to determine what types of expenses can be expensed in one year and what types should be amortized and if so over

³ The weights in its formula are as follows: materials - 12 percent, wages - 44 percent, amortization - 11 percent, other costs - 17 percent - 16 percent.

what time period. Use of standards from other codes, such as a tax code, for determining how expenses should be treated may or may not be appropriate. Fair return calculations may become political, with a commission selecting the desired result and then working backwards to justify that result. In the U.S. rate decisions may be appealed to the courts. However, the judicial decisions provide little guidance in the form of specific principles that can guide future commission decisions.

Comment on the Use of Price Indexing

Indexes offer certainty, which protects the investor and "protects" the public agency from having to make repeated unpopular price adjustments. On the other hand, the index that is selected may or may not be an indicator of what price adjustments are reasonable. The overall price index may not reflect cost increases for a particular type of public service, which has a far different basket of expenses than the basket of expenses of a typical household which is used to construct the price index. In light of the complexities and shortcomings of rate of return formulas, price indexes may be most appropriate. On the other hand, use of the overall Consumer Price Index may lead to excessive increases, especially if real wages are decreasing. Therefore, the weighted index approach may be the most appropriate.

Annual Price Adjustments Based on an Index with Periodic Adjustments of the Base Price

In Great Britain, a combination of rate of return analysis and price indexing is used to determine water prices. The initial price is set based on a cost review. Then annual adjustments are based on the overall all price index. However, the annual adjustment formula includes an adjustment so that the annual price adjustment is a specified percentage below the full percentage increase in the index. (The adjustment = RPI (Retail Price Index) - X). The "X" factor is based on the theory that the water companies should become more efficient over time. Periodic reviews are then conducted in order to readjust the base price. The first review was conducted after ten years. However, now the water regulatory authority is planning on reviews every five years. While this approach may work well in Great Britain, investors may feel that operating under this type of price control is far more risky in a nation which has a short tradition of private ownership and the application of price regulations to private firms.

CONCLUSION

Hungary is undergoing a rapid transition. In the area of local service provision, within a relatively short period, the country is introducing market economy public procurement systems, privatization of public services, and standards for setting allowable

prices for privately owned public services. These are complex tasks which more economically advanced nations are still trying to master.

Finding the best method of privatizing public services may be even more difficult and complex in Hungary than in advanced western economies, because Hungarian public agencies, rather than just searching for greater efficiency, are dependent on private firms to bring needed capital into a transition economy.

It is essential that contracts carefully spell out each of the obligations of the government and the private company providing the service. In the absence of specific contract terms, differing understandings about what is and should be expected from each party are certain to occur. The rapid introduction of long term contracting out for public services, necessitated by the need to bring in capital for public services, requires rapid growth in national and local government sophistication about public service contracting and pricing. Otherwise, there may be long term damage, in the form of long term public service contracts that fail to insure adequate services, forestall innovation, and/or permit excessive prices. If local governments pool resources in order to obtain adequate counseling and expertise. While there are costs associated with obtaining such expertise, they are usually small compared to the costs of operating without such expertise.⁴⁴

The lack of transparency serves little or no purpose at the expense of allowing corruption to be concealed, forestalling the development of independent expertise, and excluding public input on public matters. It leaves decision making in the control of government without review and accountability. While interviewees repeatedly explained that the secrecy of contracts and data submitted in order to justify price adjustments was pursuant to law and was the way that things are done, no one offered persuasive rationale for such practices. While it may be necessary to maintain the secrecy of some pieces of information associated with private provision of public services, the broad cloak of secrecy now in effect is a vestige of a long historical concept that places government in a role of master rather than servant of the public. The best results in a market economy occur when information is open so that the most honest competition and the best critical public review can be obtained. In light of the fact that Hungary is starting from a weaker economic position and a lack of contemporary tradition in contracting to private companies, it needs to be even more skillful at contracting out than governments in more advanced economies.

⁴⁴ One Hungarian consultant indicated that some localities saw their high costs for particular services as laws of nature rather than understanding how the pooling of facilities with other municipalities would drastically reduce costs.

In the course of consulting in the U.S., this author has continually faced situations in which municipalities incur substantial administrative legal expenses because they wanted to save on initial legal fees for drafting legislation and/or the municipal manager or the municipal attorney did not want to acknowledge that outside expertise was needed.